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Tuesday, August 22, 2006

Limits on the income tax

The D.C. Circuit held today that the definition of "income" in the Sixteenth Amendment does not include "damages received solely in compensation for a personal injury." More generally, a "restoration of capital" is not income, nor is “a substitute for [a] normally untaxed personal ... quality, good, or ‘asset’." If it's not income, and it's not taxable elsewhere in the Constitution (which severely limits the federal power to tax), then the federal government may not tax it, regardless of what Congress or the IRS say.

Because of the "sanctity of property" (what a refreshing phrase to read in a federal court case!), the court says it cannot defer to Congress to define what constitutes "income" and thus what is taxable under the Sixteenth Amendment. Thus, even though the Internal Revenue Code excludes from the income tax only compensation “received ... on account of personal physical injuries," compensation for emotional and reputational injuries is not "income," therefore not taxable. A good application, I'd say, of charter-based law and the principle of least authority (more commonly known in this context as the principle of enumerated powers, as opposed to the scheme of unenumerated rights per the Ninth amendment).

One interesting objection that may be raised by the IRS on appeal is that even if "restoration of capital" and compensatiion for "normally untaxed personal...asset[s]" are not taxable under the Sixteenth Amendment, they may under some circumstances (including non-physical personal injuries) be taxable under the original Constitutional grant of the power to tax to Congress. This gets us into the old argument over proportionment, direct taxation and the income tax that was current during the years before the enactment of the Sixteenth.

The grant of tax power to Congress under Article I severely limits direct taxes: "direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers." (A. 1, S. 2, C. 3). This language would have to be quite severely twisted (as it unfortunately was in some late nineteenth century cases, though not this far) to fit in a direct tax on compensation, since such a tax is not apportioned among the states according to their population, but rather is apportioned according to the amount of the compensation. That's why they passed the Sixteenth Amendment in the first place: because the Court back then would not stretch the language far enough to include a general income tax. The principle of least authority, via the Ninth and Tenth Amendments, strongly urges judges who read the Constitution thoughtfully to not interpret the necessarily concise language of the enumerated powers to include more power than ratifiers intended to grant.

The opinion was written by Douglas Ginsburg, one of my favorite judges.

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Nick Szabo

"A premier thinker about history, law and economics, and the lessons they have for security." -- Adam Shostack, Emergent Chaos

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Posted by Nick Szabo at 11:16 AM

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